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SUBJECT: FDI TO TURKEY BREAKS RECORDS

This cable has been coordinated with Congen Istanbul.

1.(SBU) Summary: After years of attracting anemic FDI inflows, in 2005 Turkey finally recorded a major inflow: $9.6 billion. The leap in FDI is attributable to large privatizations and opportunities in the financial, retail and telecoms sectors, as well as Turkey's rapid growth, EU candidate status, resolution of investor disputes, streamlined investment procedures and increasingly stable political and economic situation. While higher FDI looks set to continue through 2007 as installments for deals concluded in 2005 come due, sustaining these levels over time will require continued reforms, particularly in improving the climate for doing business and making the judicial and regulatory systems more transparent and predictable. End Summary.

Nearly Ten Billion Dollars in FDI in 2005

¶2. (SBU) For years Turkey has attracted an anemic level of FDI despite its strategic geographic position, substantial internal market, youthful population, EU customs union agreement, relatively low-cost/good quality labor force and high average annual GDP growth. The paltry FDI flows were attributed to Turkey's boom-and-bust economic instability, wobbly and anti-reform coalition governments, corruption, high taxes and an anti-foreigner and anti-private sector bias among Turkish judges and bureaucrats. From 1995 through 2000, net FDI never got above one billion dollars in a single year. Even in 2004, with two years of post-crisis stabilization and growth under its belt, Turkey attracted only $2.8 billion, of which $1.3 billion was real estate purchases by foreigners. These figures are small both in relation to GDP and in relation to comparator countries.

¶3. (SBU) Full year 2005 Balance of Payments data confirm what had become increasingly clear in the course of the year: 2005 was a turning point, and FDI has taken off. FDI inflows surged to $9.65 billion-a 239 percent increase -- of which only $1.8 billion was for real estate purchases. Using the Institute for International Finance's calculation that FDI to 29 major emerging markets totaled $135 billion in 2005, Turkey accounted for seven percent of the total for this group of countries.

	2003	2004	2005
FDI inflows to Turkey (in $ billions)	1.75	2.82	9.65
% of Turkey's GNP	0.76%	0.95%	2.7%
% of major EM FDI inflows	1.8%	2.1%	7.1%

Source: Central Bank, IIF

Why the Change?

¶4. (SBU) Though the current AK Party government has been talking a pro-foreign investment line since taking office in November, 2002, it is striking that FDI only took off in 2005. Several of the negative factors remain: corruption, high taxes, an anti-foreigner judiciary, and regulatory bias for domestic companies, as well as an over-regulated labor market that inflates the cost of hiring and firing. These factors explain the near-total absence of greenfield investment: foreign investors almost always take a local partner who knows how to work the Turkish system.

¶5. (SBU) In 2005, however, the balance clearly tipped in favor of new FDI. Among the key factors explaining the change:

--Firmed up EU accession country status: the EU's

December 17, 2004 decision to set a date to begin accession negotiations gave investors a high probability that Turkey would at least start the accession process with the launch of negotiations. The October 3 launch confirmed investors' bets. The prospects of Turkey being locked into the stabilizing, modernizing EU accession process -- even if ultimate accession is far from assured -- provides an "anchor" that gives investors a degree of confidence.

--Continued stabilization and growth of the economy: Though Turkey's economy performed well every year since the crisis, by 2005 Turkey had three straight years of strong growth, fiscal discipline, declining inflation and declining interest rates. Turkey's economy has grown 22 percent since the crisis. With the risk of another crisis greatly reduced, prospects for continued strong growth coupled with reasonable levels of inflation were key.

--Relative political stability: Turkey suffered through coalition governments throughout the 1990's, with attendant spoils-seeking and indecisveness on reform. Since the November 2002 eletion, Turkey has had three straight years of single-party, more or less pro-reform AKP government. With AK likely to hold onto power into 2007, and perhaps beyond, investors were willing to take the plunge.

--Sectoral opportunities: Certain sectors in particular held out the prospect of strong growth over the long-term. Strong current sales and excellent prospects in retail, financial, automotive, housing and white goods are partly due to the fall in inflation and both real and nominal interest rates. Turkey's thirty-plus years of high inflation and interest rates effectively eliminated access to credit for all but blue chips and wealthy individuals who could borrow offshore. When borrowing money finally became affordable, Turkey's growing middle class, encouraged by banks trying to

transition away from over-reliance on government securities portfolios, borrowed to buy cars, washing machines, housing, etc. In each sector there were other factors as well: auto and white goods companies like Turkey as a low-cost platform for export to the EU; supermarkets are taking business from mom-and-pop stores; and retail banking is underdeveloped. The telecoms sector, long dominated by the state telecoms company, is poised to take off through a combination of privatization, liberalization, internet and computer penetration, and rising incomes.

--Privatization: After years of struggling to successfully complete transactions, in 2005, the Privatization Authority finally solved some of its legal and operational problems and successfully completed three large privatizations: the Tupras oil refinery, Erdemir steel mills, and Turk Telekom. Only the latter was acquired by a majority-foreign buyer, but it was also the biggest deal: $6.5 billion to be spread over several years. Also in the telecoms sector, the bank deposit guarantee agency sold a $4.5 billion controlling share in Turkey's second-largest cell phone company, Telsim, to Vodafone of the UK, however Vodafone's purchase will only be recorded in the 2006 balance of payments.

-- Resolution of high-profile investment disputes: By the end of 2005, the AKP government had resolved, in one way or another, the high-profile investment disputes it inherited from its predecessors. For U.S. companies, this includes Cargill's problems in obtaining zoning permission for its $150 million sweetener factory near Bursa, and Motorola's settlement of its $1.8 billion claim against the bank deposit guarantee agency for a fraud committed against it and Nokia. Although other, smaller scale business issues remain, putting these headline grabbing disputes behind it has undoubtedly contributed to an improved reputation in international business circles.

-- Progress in reducing red tape and bureaucracy: Turkey's 2003 foreign investment law eliminated prior screening requirements for foreign investment, and

opened nearly all sectors to foreign investment on a national treatment basis. The World Bank's Doing Business database reports that it took 9 days and 8 procedures to create a new business in 2005, compared to 38 days and 13 procedures in 2003. Although there is more to be done, particularly in rationalizing permitting and licensing procedures, this is remarkable progress in a country long known for its oppressive bureaucracy.

Financial Sector

¶6. (SBU) Most notable was the action in the financial sector. Even though the process of privatization of state-owned banks continues to move at a snail's pace, private bank owners proved open to selling stakes or control to foreigners. Garanti Bank, which had been in negotiations with an Italian bank in 2004, agreed to sell a 50 percent stake to GE Capital of the U.S. in 2005, and the $1.8 billion payment showed up in the FDI data in December of 2005. Another major transaction was the purchase of the shares held by Cukurova group in Yapi Kredi Bank by a consortium of Koc Group and Unicredito of Italy. BNP of France bought a stake in TEB. A Greek bank bought a small brokerage. Benelux-based Fortis Group bought control of Dis Bank. All in all, the share of foreign ownership in the banking sector rose from 3% to 13%, according to the Bank

Regulatory Agency.

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Long-term financing in the Balance of Payments
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¶7. (SBU) FDI benefits Turkey in a number of ways: access to international expertise and technology, better integration into an increasingly globalized international economy, and long-term, non-debt-creating finance for the balance of payments. The latter is particularly welcome now, since Turkey's current account deficit suged in 2005, largely due to sharply higher energy imports. FDI, as opposed to short-term portfolio investment, provides a stable source of financing that cannot run for the exits in a downturn.

FDI likely to continue in 2006 and 2007

8.(SBU) As good as the news of strong FDI inflows in 2005 is the near-certainty these inflows will continue in 2006 and 2007. Many of the above-mentioned transactions, such as Turk Telekom and Telsim, call for the buyer to pay in instalments over several years. The Vodafone deal will show up in 2006 FDI. Moreover, the market is rife with rumors and plans for new deals. For example, Finansbank, Denizbank, and Akbank have all retained advisors for sale of their shares or of a controlling stake. At the same time, the state bank privatization process finally looks like it might pull off a sale of Halk Bank.

9.(SBU) In a recent poll of its members, the Turkish Foreign Investors' Association, YASED, found foreign investors in a bullish frame of mind. 73% expected the economic climate for FDI likely to get better, 27% thought it would stay the same and none thought it would get worse, while 51% thought they would be making additional investments in the future.

¶10. (SBU) Still, sustaining over the long term the high levels of FDI Turkey needs to create jobs and catch up with EU living standards will require continued reforms to improve the business and investment climate. In addition to reducing still complicated business registration procedures, licensing requirements and other bureaucratic red tape, the World Bank's "Doing Business" database shows that Turkey compares unfavorably with competitor countries in area of labor market regulation, particularly the ease of hiring and firing workers
http://www.osis.gov/state/posts/turkecon/2005 /12/PRN_do

ing_business_1.html). Easing up on these regulations and fostering a more entrepreneurial environment will be a political challenge for this or future governments.

WILSON